MAY 1 4 1991

District Director, Los Angeles, CA
attn: Morris Kahn, CE 1204

Chief, CC:IT&A:05

Pre-Section 90 Irrigation Subsidies
TR-45-0353-91

This is in reply to your request, dated March 5, 1991, for assistance to your District on the issue of whether illegal federal irrigation subsidies received by a taxpayer before or after the effective date of section 90 of the Internal Revenue Code, January 1, 1988, are includible in income. You also ask whether in both situations a deduction would be denied.

The facts surrounding this particular question were discussed in a telephone conversation on May 10, 1991 between George Wright of this office and Morris Kahn. Mr. Wright gave an example of a taxpayer paying $40 for water that was worth $100 whereby the illegal subsidy would result in $60 of income to the taxpayer. Likewise, the deduction issue pertains to whether the taxpayer can now somehow claim this $60 should also be allowed as a deduction. Since the facts do not indicate the taxpayers have or will have to pay the $60 to the federal government, it was agreed that it would not be necessary in this response to address the deductibility issue when payments are actually made for the subsidy amount. Based on the above we conclude as follows:

Income Issue

Gross income, as defined in section 61(a) of the Code, includes all income from whatever source derived, unless specially excluded. Section 1.61-1(a) of the Income Tax Regulations provides that gross income means all income from whatever sources derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash.

For irrigation subsidy income received after January 1, 1988, section 90 of the Code provides that the term "illegal federal irrigation subsidy" means the excess (if any) of (A) the amount required to be paid for any federal irrigation water ~~delivered to the taxpayer over (B) the amount paid for such~~

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water. Section 90 further defines the term "federal irrigation water" as "any water made available for agricultural purposes from the operation of any reclamation or irrigation project referred to in paragraph (8) of section 202 of the Reclamation Reform Act of 1982. The amount of any "illegal federal irrigation subsidy" shall be included in the gross income of the taxpayer during the taxable year and no deduction shall be allowed for such inclusions.

For the treatment of subsidy income prior to January 1, 1988, one must look to the appropriate tax case law. We have found the following:

Monroe Swan v. Commissioner, T.C.M. 1985-521, holds that when a state senator appropriated the services of federally paid CETA youth workers to assist in his campaign for lieutenant governor, his use of 20 to 50 percent of their working time constituted unreported income in the amount of those percentages of their wages paid.

Norman Mais v. Commissioner, 51 T.C. 494 (1968), holds that in a case of embezzlement in which there was partial restitution in the same year and part in a subsequent year, the full amount appropriated and not returned during the first year was to be included in income.

In Baboquivari Cattle Company v. Commissioner, 135 F. 2d 114 (9th Cir. 1943), it was held that government benefit payments made under the Soil Conservation and Domestic Allotment Act, 49 Stat. 163 (enacted April 27, 1935) for dirt reservoirs, earthen tanks, and a rubble masonry dam, constituted taxable income to the recipient, operator of a cattle ranch on land held under long term grazing leases. The taxpayer had claimed that such payments for improvements were "capital subsidies" rather than "income subsidies", but the B.T.A. and 9th Circuit refused to create a distinction and exception from the general rule that found such unrestricted payments to be income under Eisner v. Macomber, 252 U.S. 189 (1920).

Rev. Rul. 84-67, 1984-1 C.B. 28, distinguished Baboquivari to find such an exception to the general rule of inclusion in income under section 61 of the Code for the excludable portion of cost sharing payments received under the forestry incentives program (F.I.P.) authorized by the Cooperative Forestry Assistance Act of 1958. However, this was only true because section 126(a) of the Code was enacted to provide a specific exception for the excludable portion of cost-sharing payments. Formerly, Rev. Rul. 76-6, 1976-1 C.B. 176, had held such F.I.P. payments includible in income in the year received.

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The Baboquivari case demonstrates that the general treatment of federal subsidy payments is income. Rev. Rul. 84-67 found an exception for the F.I.P. program payments, but only because of specific legislation (section 126 of the Code). The general rule had been set out in Rev. Rul. 76-6, in which F.I.P. payments were includible in gross income. The Swan case indicates stolen CETA services are includible in gross income. There should be no difference in treatment for the subsidized water taken illegally by a taxpayer not qualified to receive it, even before January 1, 1988.

Deduction Issue

Section 90 of the Code addresses the question of a deduction for years after January 1, 1988. That section concludes with the statement that the amount of any "illegal federal irrigation subsidy" shall be included in the gross income of the taxpayer during the taxable year and no deduction shall be allowed for such inclusions.

With respect to years prior to January 1, 1988, we believe that the correct result would be that if the taxpayer was on the cash receipts and disbursements method of accounting and has not paid the $60 subsidy payment, then the taxpayer obviously is not entitled to the deduction. If the taxpayer is on the accrual method of accounting, then the taxpayer must establish under section 461 of the Code that all events have occurred which determine the fact of liability and the amount thereof can be determined with reasonable accuracy. Since these amounts were never paid and no action was ever brought to collect the subsidy, it would certainly seem questionable whether any liability ever existed for the subsidy and no deduction should be allowed.

We therefore conclude that even before the effective date of section 90 of the Code, federal irrigation subsidy income was gross income subject to federal income taxation, and should not result in a deduction.

(signed) David L. Crawford

David L. Crawford, Jr.